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SUPREME COURT OF THE UNITED STATES

OCTOBER 1947 TERM

No. 682

WARREN J. HARANG,
Petitioner,

versus

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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[Of Counsel]

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Warren J. Harang prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered in the above cause on the 30th day of December, 1947, reversing a judgment of the United States District Court for the Eastern District of Louisiana.

THE OPINION BELOW.

The Judge of the United States District Court wrote an opinion holding that the plaintiff was entitled to recover and setting out findings of fact and conclusions of law. (Tr. 75-82). *Harang v. United States,* 68 Fed. Supp. 227.

The opinion of the United States Circuit Court of Appeals is reported as "United States of America v. Warren J. Harang" (Record 87).

JURISDICTION.

The judgment of the United States Circuit Court of Appeals was entered on the 30th day of December, 1947 (Record 99). The jurisdiction of this court is invoked under Section 240 of the Judicial Code as amended by the Act of Feburary 13, 1925 (28 U. S. C. A. § 347).

THE QUESTION PRESENTED.

(1) The question presented is whether, under Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447 and Section 22 (a) of the Internal Revenue Code of 1934, income growing out of the ownership, or use of, or interest in, real estate in Louisiana, received as royalties from an oil and gas lease may be treated as a partial alienation of the real estate, instead of as income.

(2) The question presented is whether royalties from a mineral lease covering property in Louisiana can be treated as other than income, so as to destroy the uniformity of the application of the Internal Revenue laws of the United States, and more particularly the application of Section 22 (a) of the Internal Revenue Code of 1934, as amended.

(3) The question presented is whether this case, reaffirming the principle of *Commissioner of Internal Revenue v. Gray*, 159 Fed. (2d) 834 (Fifth Circuit), holding that royalty from a mineral lease is a consideration for the

partial alienation of real estate, is to prevail over the conflicting opinions of *Commissioner of Internal Revenue v. Fleming,* 82 Fed. (2d) 324 (Fifth Circuit); *Pettit v. Commissioner of Internal Revenue,* 118 Fed. (2d) 816, (Fifth Circuit); *Lee v. Commissioner of Internal Revenue,* 126 Fed. (2d) 825, (Fifth Circuit); *Sunray Oil Company v. Commissioner of Internal Revenue,* 147 Fed (2d) 962, (Tenth Circuit).

STATUTE INVOLVED.

Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447 and Section 22 (a) of the Internal Revenue Code.

STATEMENT.

For the purpose of trial, it was stipulated that the suit was brought under Section 24 of the Judicial Code, Paragraph 3 (28 U. S. C. 41 (20)), and was properly brought against the United States; that Warren J. Harang is a resident of Louisiana and paid tax deficiencies for the years 1942 and 1943 in the sum of $11,892.45, for which claims for refund were timely made and rejected; that the income upon which the deficiencies were claimed was for the receipt of royalties under a drilling contract for oil and gas; that the property subject to the lease was situated in Louisiana and was the separate property of Warren J. Harang; that the plaintiff was married under the system of the community of acquets and gains, and the income was returned as community income; that the Commissioner claimed that royalties from the separate property of the plaintiff was not community income, but the receipt of a

consideration for the partial alienation of real estate and assessed the deficiencies. (Record 43-46).

Article 2402 of the Revised Civil Code of Louisiana provides as follows:

> "*Art. 2402:* "This partnership or community consists of the *profits* of all the effects of which the husband has the administration and enjoyment, either of right or in fact, of the produce of the reciprocal industry and labor of both husband and wife, and of the estate which they may acquire during the marriage, either by donations made jointly to them both, or by purchase, or in any other similar way, even although the purchase be only in the name of one of the two and not of both, because in that case the period of time when the purchase is made is alone attended to, and not the person who made the purchase."

If the opinion in this case were to stand alone, it would appear that the decision rested upon only an interpretation and application of Louisiana law. The decision, however, is more far reaching than a decision of local law, because it involves a question of Federal income tax law. The decision is in conflict with decisions on the same question by other Circuit Courts of Appeals and in conflict with decisions in the Fifth Circuit Court. The judgment which this court is asked to review reaffirms the judgment in the case of *Commissioner of Internal Revenue v. Gray*, 159 Fed. (2d) 834. The Circuit Court of Appeals in this case said:

> "We find no error in the decision in the Gray case, and accordingly it is reaffirmed." (Record 97).

If the decision in the *Gray* case is correct, then certiorari should be denied in this case, but if the decision in the *Gray* case is incorrect, then certiorari should be granted to review the judgment and correct the error of the *Gray* case. It, therefore, becomes imperative that the decision of the *Gray* case, which is the foundation of this case, should be examined. In the *Gray* case, the Court of Appeals for the Fifth Circuit, under facts precisely similar to this case, *held that royalties were not income like rent for the use of property, but were a consideration for the partial alienation of the property.* In the *Gray* case, the court said: (842)

> "*As the execution by the fee owner of an oil and gas lease is a dismemberment of the property amounting to a partial alienation, and the bonus is the cash consideration paid therefor*, it follows that a bonus paid the taxpayer for an oil and gas lease fell into his separate property". (Italics ours).

The denial that royalties are income, as provided by the Internal Revenue Code and as provided by the law of Louisiana, (Act 21 of 1924, as amended; Sec. 8587.31 p. 229, Dart's General Statutes of Louisiana, Vol. 6), but are a consideration for the alienation of real estate, was the basis of deciding against the taxpayer. The decision complained against produced the anomaly that although royalties, under the Internal Revenue Code, are income and not profit, or a capital gain from the sale of property, yet the decision of the Circuit Court of Appeals produces the contradictory situation that royalties are a capital gain, but cannot be treated as a capital gain, but must be re-

turned as ordinary income. If these royalties are the consideration for the alienation of the real estate of the husband, they fall into his separate income, but if they are ordinary income from his separate property, they fall into the community. *Bender v. Pfaff*, 272 U. S. 127.

The fact that the court was dealing with royalties from the separate property of the husband, for the purpose of ascertaining their final destination, does not interdict the application of the principle that royalties are income from the use of property and not a consideration for a partial alienation. The final destination of these royalties, whether as separate income or community income, does not change their nature, under the decisions of Louisiana, as rent, nor, under the Internal Revenue Code, as income. If royalties are a consideration for the partial alienation of real estate, then these royalties, for every purpose and in every conceivable situation, must be a consideration for the sale of real estate. These royalties cannot be the consideration for the alienation of real estate in the case of a married man and income in the case of a single man. If royalties are a consideration for the sale of property, they must be so in every oil and gas contract, and if not income, then returnable as a capital gain. They cannot at one time be both.

Royalties under a contract with an unmarried man cannot be gross income, but royalties from a contract with a married man a consideration for the partial alienation of real estate. If that be so, then the nature of royalties as gross income would vary with the circumstance of whether the recipient is unmarried or is married. This concept of variation, dependent upon the marital status of

the recipient of the royalties, if permitted to exist, because of the *Gray* case and its reaffirmation in the Harang case, would destroy the uniformity of the taxing statutes, which the courts aim to preserve. If royalties are a consideration for a partial alienation of real estate, they are the purchase price of land and returnable as a capital gain. However, Congress has enacted otherwise. If the command of Congress be obeyed, they are income, and, if income from the separate property of the husband, they are community income and returnable as such. If they are not income, they may be returned as a capital gain. Congress and the Courts forbid such a return.

Under the law of Louisiana the profits from the separate estate of the husband fall into the community. *Glenn v. Elam*, 3 La. Ann. 611; *Cooper v. Cappel*, 20 La. Ann. 213, 215; *Denegre v. Denegre*, 30 La. Ann. 275, 276; *Smith v. Riddick*, 42 La. Ann. 1055; *Succession of Weber*, 49 La. Ann. 1494. The rental from the separate property of the husband is a profit from the property and is community income. *Barbin v. Couvillon*, 122 La. 407; *Succession of Goll*, 156 La. 910; *Peters v. Klein*, 161 La. 664, 667. It is the uniform jurisprudence of Louisiana that royalties are rent:

> "It is well settled that the paying of a royalty under a mineral lease, is the paying of rent. *Spence* v. *Lucas*, 138 La. 763, 70 So. 796; *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 373; *Roberson v. Pioneer Gas Co.*, 173 La. 313, 137 So. 46; 82 A. L. R. 1264. *Shell*

Petroleum Corp. v. Calcasieu Real Estate and Oil Co., et al., 185 La. 751, 170 So. 791".

"On several occasions this court has decided that the usual oil and gas lease, with a cash or royalty consideration, or both, such as presently before us, is a contract of letting and hiring within the meaning of the codal articles, and therefore does not create a servitude on the realty or a real right in the land. *Cooke v. Gulf Refining Co.*, 127 La. 592; 53 So. 874; *Rives v. Gulf Refining Co.*, 133 La. 178, 62 So. 623; *Cook v. Gulf Refining Co.*, 135 La. 609, 65 So. 758; *Gulf Refining Co. v. Hayne*, 138 La. 555, 70 So. 509, L. R. A. 1916D, 1147, Ann. Cas. 1917D, 130; *Spence v. Lucas*, 138 La. 763; 70 So. 796; *Hennen's Digest*, Vol. 1, 479, 480; *Allen v. Shreveport Mutual Bldg. Ass'n.*, 183 La. 521, 525, 164 So. 328; and articles 2669, 2670, 2671, 2674, 2679 of the Revised Civil Code". *Gulf Refining Co. of Louisiana v. Glassel, et al.*, 186 La. 190, 171 So. 846, 848.

"This court has also firmly established the rule that mineral leases would be construed as leases and the codal provisions applicable to ordinary leases would be applied thereto insofar as they may be". *Tyson v. Surf Oil Co.*, 195 La. 248, 196 So. 336, 342.

" 'Under the jurisprudence of this State "It is well settled that the payment of royalty, under a mineral lease, is the payment of rent' ". *Robinson v. Horton, et al.*, 197 La. 919, 2 So. (2d) 647, 649.

" 'The rule is well established that mineral leases *must* be construed as leases, and that the codal pro-

visions applicable to ordinary leases *must* be applied. *Tyson v. Surf Oil Co.*, 195 La. 248, 196 So. 336' ". *Coyle v. North American Oil Consolidated, et al.*, 201 La. 99, 9 So. (2d) 473, 478.

The Circuit Court of Appeals in this case did not discuss fully the applicable principles of Federal income statutes, but based its decision largely upon the ground that the Civil Code of 1808 used the word "fruits", and that the translators of the Code into English, in the Code of 1825, had substituted the word "profits". The Court then held that the word "fruits" was the proper word to be used in applying Article 2402 of the Revised Civil Code of 1870. The Court held that notwithstanding the Code of 1825 had constitutionally been enacted in English and not in French, nevertheless, the terms of the Civil Code of 1808 prevailed. The Court held that the controlling word in Article 2402, Revised Civil Code of 1870, was "fruits" and not "profits" as found in the Code of 1870, which is the latest. The Court overlooked the fact that whatever argument there might be as to whether the Code of 1825 was constitutionally enacted in English or in French that the Legislature by Act 68 of 1902 had re-enacted Article 2402 Revised Civil Code, as quoted above, and that the Legislature had used the word "profits" and not the word "fruits". The Circuit Court of Appeals did not discuss the unquestioned use of the word "profits" by the Legislature in 1902, so that regardless of what had occurred

before 1902 "profits" and not "fruits" is the determinative term regarding royalties from the separate property of the husband.

Whatever be the effect of the law of Louisiana, whether correctly or incorrectly interpreted by the Circuit Court of Appeals, is not material to a decision in this case. The question fundamentally is whether royalties are income or a consideration for the sale of property when tested by provisions of Federal income taxation. The unbroken line of jurisprudence of this Court is that royalties are income and returnable as income and not as a gain or loss from the sale of real estate. *McLean v. Commissioner of Internal Revenue*, 120 Fed. (2d) 942 (Fifth Circuit); *Staunton Industrial Loan Corporation v. Commissioner of Internal Revenue*, 120 Fed (2d) 930-935 (Fourth Circuit); *Burnet v. Harmel*, 287 U. S. 103; *Morgan v. Commissioner*, 309 U. S. 78-80; *Helvering v. Stuart*, 317 U. S. 154-162; *Anderson v. Helvering*, 310 U. S. 404-407; *Douglas v. Commissioner of Internal Revenue*, 322 U. S. 275-280.

CONCLUSION.

The decision in this case, based upon the decision in the *Gray* case, is in conflict with the holdings of other circuits on the question of the nature of royalties and is clearly and directly opposed to the principles enunciated by this Court in various and unvarying decisions. If royalties in oil and gas leases in Louisiana are not income, but are a consideration for the partial alienation of real estate, then, inevitably, these royalties are not to be returned as ordinary income, but may be returned as a capital gain.

Will the Commissioner of Internal Revenue permit a Louisiana taxpaper to return royalties as a consideration for the alienation, either partial or whole, of real estate on the basis of a capital gain and demand that taxpapers in other states return such royalties as gross income? Unless certiorari be granted and the principle of the *Gray* case and this case be abrogated, that must be the logical and legal result.

It is, therefore, respectfully submitted that for the reasons stated herein this petition for a writ of certiorari should be granted.

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March, 1948.

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No. 682

WARREN J. HARANG,
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versus

UNITED STATES OF AMERICA,
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ORIGINAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

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ORIGINAL BRIEF

IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

May It Please the Court:

This case considered, if standing alone and unrelated to the decision of *Commissioner of Internal Revenue v. Gray*, 159 Fed. (2d) 834, would be merely an interpretation and application of the local law of Louisiana. Analyzed for its importance to the taxing statutes of the United States, it must appear that the case involves a Federal question and not a local question. While the opinion deals with a historical interpretation of Louisiana law, yet its substance is found in the reaffirmation of the principle of the *Gray* case. That case is contradictory of the deci-

sions of the Circuit Courts of Appeals of the circuits and is opposed to decisions in the Fifth Circuit.

Even if that were not so, the principle of the *Gray* case, reaffirmed in this case, is wholly destroyed by the decisions of this Court. If the decision of this case, based upon a decision of the *Gray* case, affected merely the destination of royalties as between the separate income of the husband, or the community existing between the husband and the wife, then it is conceivable that this Court would not grant certiorari. However, the need of reviewing the judgment of the Circuit Court of Appeals is imperative if the jurisprudence relating to the Federal income tax is to be kept in a straight current, and its uniformity preserved.

Under the law of Louisiana, the husband is the head and master of the community. As such, he has the absolute right of managing his own property and has the right to manage the separate property of the wife, unless she should assert her right of sole and uncontrolled management. The income from the separate property of the husband falls into the community and the income from the separate property of the wife likewise falls into the community, unless the wife retains the sole management of her own property. (Article 2402, Revised Civil Code, and Article 2386, Revised Civil Code).

It is unquestionable that under the law of Louisiana the word "fruits" has a different meaning from the word "profits". However, whatever be the difference in

meaning, Article 2402 of the Revised Civil Code, provides as follows:

> ART. 2402. *Property forming community—Personal injuries to wife.*—This partnership or community consists of the profits of all the effects of which the husband has the administration and enjoyment, either of right or in fact, of the produce of the reciprocal industry and labor of both husband and wife, and of the estate which they may acquire during the marriage, either by donations made jointly to them both, or by purchase, or in any other similar way, even although the purchase be only in the name of one of the two and not of both, because in that case the period of time when the purchase is made is alone attended to, and not the person who made the purchase.

Louisiana has adopted the fugacious theory of oil and gas. *Frost Johnson Lumber Co. v. Sallings' Heirs*, 150 La. 756. The surface owner does not own the oil and gas until reduced to possession. The owner of the land has only a right to drill for oil and gas and when reduced to possession becomes the owner. When the owner of the land contracts with another for the exercise of the right to drill for oil and gas, the consideration is usually denominated as royalties. "Mineral leases will be construed as leases and not sales". *Spence v. Lucas*, 138 La. 763. Rent is the consideration for such a contract, notwithstanding it may be termed "royalty". *Board of Commissioners of Caddo Levee District v. Pure Oil Company*, 167 La. 801, 811; *Roberson v. Pioneer Gas Company*, 173 La. 313, 319; *Shell Petroleum Corporation v. Calcasieu Real Estate Co.*,

185 La. 751, 771; *Glassell v. Gulf Refining Co.*, 186 La. 190. Rent from the separate property of the husband is community income. *Barbin v. Couvillon*, 122 La. 407; *Succession of Goll*, 156 La. 910; *Peters v. Klein*, 161 La. 664.

> " 'It is well settled that the paying of a royalty under a mineral lease, is the paying of rent. *Spence v. Lucas*, 138 La. 763, 70 So. 796; *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 373; *Roberson v. Pioneer Gas Co.*, 173 La. 313, 137 So. 46, 82 A. L. R. 1264.' " *Shell Petroleum Corp. v. Calcasieu Real Estate and Oil Co., et al.*, 185 La. 751, 170 So. 791.

The income tax law of Louisiana is substantially the same as the income tax statutes of the United States. (*Louisiana General Statutes, Dart*, Sec. 8587.31 p. 229). Rent from the separate property of the husband falls into the community.

Regardless of Louisiana law, it is clear that the statement in the *Gray* case, reaffirmed in this case, that royalty is the consideration for the partial alienation of land contravenes the unvaried jurisprudence of this Court that royalty is ordinary income and must be returned as such, and not as a capital gain from the sale of land. In the *Gray* case it is said:

> "As the execution by a fee owner of an oil and gas lease is a dismemberment of property amounting to a partial alienation and the bonus is the cash consideration paid, therefore, it follows that the bonus

paid the taxpayer for an oil and gas lease falls into his separate estate".

The statement implies that such a lease is a sale and that the consideration therefor is not income. We respectfully say that this statement is in direct conflict with *McLean v. Commissioner of Internal Revenue*, 120 Fed. (2d) 942 (Fifth Circuit). In that case, McLean transferred to the Yount-Lee Oil Company his interest in certain proved leases for a consideration of $500,000.00 cash and $2,000,000.00 to be paid out of 1/8 of the gross oil produced and saved from the leases. McLean treated the consideration as the price of a sale and not as income. The Commissioner disallowed the contention and held, regardless of the manner of payment, that the consideration received by him was income.

The court said:

> "Without undertaking any detailed or nice analysis of the language in the instrument upon which taxpayer relies we think it plain that the transaction as a whole comes strictly within the ruling in Palmer v. Bender and Burnet v. Harmel, Cf. Morrow v. Scofield, 5 Cir., 116 F. (2d) 17, and Pettit v. Commissioner, 5 Cir., 118 F. (2d) 816. Precisely as in Palmer v. Bender, the taxpayer here, in the instrument of transfer, reserved in himself an interest in the oil in place, and thereby and as a result thereof, secured for himself, 'income derived from the extraction of the oil to which he must look for a return of his capital'.

"Precisely as in Palmer's case, the taxpayer here retained a right to a share in the oil as produced and an economic interest in the oil in place which is depleted by production. Precisely as in that case, the taxpayer obtained as part consideration, for letting the sub-lessee in, a part of the fruits of the land as they might be produced, both as to the royalty and as to the payments in oil. Nothing either in the opinion in the Elbe case or in the application of its principles to its facts, affords taxpayer any comfort. The opinion re-affirms Palmer v. Bender and the result there was reached because there was no reservation of royalty, there was no retention of ownership of or interest in, the minerals in place. There was only a personal covenant to pay the taxpayer, not out of minerals in place, but out of the net proceeds of a processing or manufacturing operation".

Burnet v. Harmel, 287 U. S. 103, clearly controls this case, and, we respectfully say, demonstrates the clear conflict between the decision in the *Gray* case and in the cited case. In that case, Harmel owned land in Texas, where oil and gas in place is, under the Texas law, a part of the realty. He granted a lease "in return for bonus payments aggregating $57,000.00 in cash and stipulated royalties measured by the production of oil and gas by the lessee". He reported the $57,000.00 as gain from a sale of capital assets. The Commissioner treated the payments as ordinary income and assessed the tax at the higher rate. The court, following *Ferguson v. Commissioner*, 45 Fed. (2d) 573, held that because Texas law regarded an oil and

gas lease as a sale of the oil and gas in place, the $57,000.00 was taxable as a capital gain.

This Court granted certiorari and reversed. Regarding the contention that the bonus payment was to be treated as capital gain, the court said:

> "The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease, and the taxation of one as ordinary income does not act as a deterrent upon conversion of capital assets, any more than the taxation of the other".

The *Gray* case treats the royalties received by the taxpayer as a consideration for the sale of a capital asset and seeks to differentiate it from ordinary rent by saying that the rent intended by the Louisiana law is rent for non-consuming property. This differentiation is disposed of by your Honors as follows:

> "It was argued that since the net result of the mining operation is a conversion of capital investment as upon a sale, the money received by the corporate owner or lessor, being its capital in a changed form, could not rightly be deemed to be income. But that argument was rejected, both with respect to the proceeds of mining operations carried on by the corporate owner on its land, *Stratton's Independence v. Howbert, supra; Goldfield Consolidated Mines Co. v. Scott*, 247 U. S. 126; see *Stanton v. Baltic Mining Co.*, 240 U. S. 103, 114, and with respect to payments made by the lessee to the corporate lessor un-

der the provisions of a mining lease. *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 522; *United States v. Biwabik Mining Co.*, 247 U. S. 116". *Burnet v. Harmel (Supra).*

The court then reviewed the history of congressional enactments and said that, with the juridical history before it, Congress intended that payment of royalties was income. It further said:

> "Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. See *Weiss v. Weiner*, 279 U. S. 333, 337; *Burk-Waggoner Oil Assn. v. Hopkins*, 269 U. S. 110; *United States v. Childs*, 266 U. S. 304, 309. State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. See *Crooks v. Harrelson*, 282 U. S. 55; *Poe v. Seaborn*, 282 U. S. 101; *United States v. Loan & Building Co.*, 278 U. S. 55; *Tyler v. United States*, 281 U. S. 497; see *Von Baumbach v. Sargent Land Co., supra*, 519".

The court further said that the title to the oil and gas lease passes from the landowner when he conducts

mining operations on his own land, but as was pointed out in *Stratton's Independence v. Howbert*, since that

> "is only an incident to the use of his land for oil production, the operation, considered in its entirety, cannot be viewed as a sale or a conversion of capital assets. Like considerations govern here".

The court further said:

> "Bonus and royalties are both consideration for the lease and are income of the lessor".

In the final analysis, the fundus of the issue is not Louisiana law. The issue involves the uniform application of the laws of Congress. The incidence of congressional taxation falls on income and capital gains. Each is treated differently, but, at the threshhold of the inquiry, must be found the answer as to whether royalties represent income, or the proceeds of an alienation.

In the *Gray* case, it is said:

> "An oil and gas lease is a dismemberment of the property amounting to a partial alienation and bonus is the cash consideration paid therefor".

If, generically, a mineral lease is an alienation of the estate, the fact that it is partial does not destroy the genus. The command of Congress is that the Commissioner of Internal Revenue shall not consider royalties as the proceeds of an alienation, whether partial or whole, but shall consider these royalties as income. Whenever a taxpayer has claimed the right to return royalties on the basis of a sale of a capital asset, with the privilege of paying the

smaller tax, the attempt has been consistently resisted by the Commissioner. Will the Government in this case admit that a mineral lease is an alienation of the real estate, belonging to the taxpayer, whether partial or whole, and permit the taxpayer to return the royalties as a capital gain? Is there any case in which the Commissioner has conceded that a mineral lease is an alienation and royalties are capital gains and not income? If the Commissioner concedes that royalties are the purchase price received for the alienation of real estate, then, the Commissioner must concede that royalties are not to be treated as income, but as capital gains and taxed as such. Congress has enacted that royalties are income and nothing in the law of Louisiana, either by terminology, or by legislation, can destroy their nature. However, the concept of royalties as rent under the law of Louisiana, does not conflict with the congressional determination but, on the contrary, harmonizes with the congressional choice.

Sec. 22. Gross Income.

> (a) *General Definition.*—"Gross income" includes gains, *profits,* and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, *growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profit, and income derived from any source whatever.* * * * (26 U. S. C. 1940 ed., Sec. 22). (Italics ours).

The provisions of Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447, are identical with the quoted provisions of Section 22 (a) of the Internal Revenue Code.

The contract by which the royalties are created is a matter of Louisiana law, but when royalties are the result of the Louisiana contract, the power of Congress attaches and makes them income. "Once rights are obtained by local law, whatever they may be called, these rights are subject to the federal definition of taxability". *Helvering v. Stuart*, 317 U. S. 154, 162. State law creates legal interest and rights. The federal revenue acts designate what interests or rights, so created shall be taxed. *Morgan v. Commissioner*, 309 U. S. 78, 80.

> ". . . Furthermore, we are mindful that, wherever possible, federal taxing statutes are to be uniformly interpreted. Cf. *Burnet v. Harmel*, 1932, 287 U. S. 103, 110, 53 S. Ct. 74, 77 L. Ed. 199; *Thomas v. Perkins*, 1937, 301 U. S. 655, 659, 57 S. Ct. 911, 81 L. Ed. 1324; *Lyeth v. Hoey*, 1938, 305 U. S. 188, 194, 59 S. Ct. 155, 83 L. Ed. 119, 119 A. L. R. 410. Also, cf. *New York v. Feiring*, May 26, 1941, 61 S. Ct. 1028, 85 L. Ed.........; *Commissioner v. Greene*, 9 Cir., April 21, 1941, 119 F. (2d) 383. As Mr. Justice Stone recently stated in *United States v. Pelzer*, March 3, 1941, 61 S. Ct. 659, 661, 85 L. Ed. ......: 'But as we have often had occasion to point out the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state con-

trol or limitation unless the language or necessary implication of the section involved makes its application dependent on state law.'" *Staunton Industrial Loan Corporation v. Commissioner of Internal Revenue*, 120 F. (2d) 930, 935.

The issue here is not one of state law, but of Congressional enactment. Whatever views based on comparison and analogies courts might have otherwise adopted if Congress had not acted, "*Congress, has recognized the peculiar character of the business of extracting natural resources. Leases are a method of exploitation of the land for oil and payments under leases are 'income to the lessor' like payments of rent*". *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25. (Certiorari to Fifth Circuit).

Since Congress has said that what the petitioner received was income, and not the consideration of an alienation, either partial or otherwise, that income should be treated like any other income. Congress has made no distinction between forms or sources of income. Since the right has been recognized of spouses living under the community system to treat as community income the income received as rent for the letting of a house, or a building there is no reason to treat these royalties otherwise than as community income, since royalties are rent. *(Burton-Sutton Oil Co. v. Commissioner*, supra). It would be a fantastic system of laws if Congress could treat royalties as rent and, therefore, income for the purpose of taxation, and yet, when it comes to its return as income by the community, to treat it differently from other income. Until Congress has declared that royalties, considered as in-

come, shall be treated differently from all other income, it follows logically that like every other species of income, it is subject to the local law as to ownership. Since the right, under local law, to return rent from the separate property of the husband as community income has been recognized, the Commissioner must find some basis for differentiating the income, received as royalties, from the income received as rent for a building, in order to treat royalties differently from every other species of rent.

> ". . . Royalty or bonus payments in advance of actual extraction of minerals are, like sales after severance of royalty payments on actual production, gross income and not a recovery of capital. *Stratton's Independence v. Howbert*, 231 U. S. 399, 418; *Stanton v. Baltic Mining Co.*, 240 U. S. 103, 114; *Burnet v. Harmel*, 287 U. S. 103; *Herring v. Commissioner*, 293 U. S. 322, 324. Cf. *Anderson v. Helvering*, 310 U. S. 404, 407, 407-8." *Douglas v. Commissioner of Internal Revenue*, 322 U. S. 275, 280.
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> "Oil and gas reserves like other minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. *Burnet v. Harmel*, 287 U. S. 103, 106-107; *Bankers Coal Co. v. Burnet*, 287 U. S. 308; *United States v. Biwabik Mining Co.*, 247 U. S. 116; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 522; *Stratton's Independence v. Howbert*, 231 U. S. 399, 414. The depletion effected by pro-

duction is likened to the depreciation of machinery or the using up of raw materials in manufacturing. *United States v. Ludey*, 274 U. S. 295, 302, 303; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370." *Anderson v. Helvering, Commissioner of Internal Revenue*, 310 U. S. 404, 407-408.

"We need not decide whether technical title to the oil while in the ground was in assignors, or in assignee. The federal income tax Act is to be given a uniform construction of nation-wide application except insofar as Congress has made it dependent on state law." *Thomas, Collector v. Perkins, et al.*, 301 U. S. 655, 659.

"The state law creates legal interests, but the federal statute determines when and how they shall be taxed. We examine the Texas law only for the purpose of ascertaining whether the leases conform to the standard which the taxing statute prescribes for giving the favored treatment to capital gains. Thus tested, we find in the Texas leases no differences from those leases where the title to the oil and gas passes only on severance by the lessee, which are of sufficient consequence to call for any different application of section 208 (26 U. S. C. A. Int. Rev. Acts, page 13). The fact that title to the oil and gas is said to pass before severance rather than after, is not such a difference. The economic consequences to the lessor of the two types of lease are the same." *Burnet v. Harmel*, 287 U. S. 103, 53 S. Ct. 77.

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"Moreover, the statute speaks of a 'sale', and these leases would not generally be described as a 'sale' of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas. By virtue of the lease, the lessee acquires the privilege of exploiting the land for the production of oil and gas for a prescribed period; he may explore, drill, and produce oil and gas if found. Such operations with respect to a mine have been said to resemble a manufacturing business carried on by the use of soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence v. Howbert*, 231 U. S. 399, 414, 415; see *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521."

". . . The very idea of the income tax from a constitutional viewpoint implies a differentiation between that which is capital and that which is the product or yield of capital. Nevertheless, the Supreme Court has definitely set this controversial point at rest. Since the decision of the Supreme Court in *Stratton's Independence v. Howbert*, 231 U. S. 399, 418, 34 S. Ct. 136, 58 L. Ed. 285, it has been settled that income derived from the sale of products from a mine or oil well is gross income from the operation of a business and not a recovery of capital."

. . .

"In *Anderson v. Helvering*, 310 U. S. 404, 407, 408, 60 S. Ct. 952, 954, 84 L. Ed. 1277, the court said: 'The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. *Burnet v. Harmel*, 287 U. S. 103, 106, 107, 53 S. Ct. 74, 75, 77 L. Ed. 199; *Bankers Coal Co. v. Burnet*, 287 U. S. 308, 53 S. Ct. 150, 77 L. Ed. 325; *United States v. Biwabik Mining Co.*, 247 U. S. 116, 38 S. Ct. 462, 62 L. Ed. 1017; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 522, 37 S. Ct. 201, 206, 61 L. Ed. 460; *Stratton's Independence v. Howbert*, 231 U. S. 399, 414, 34 S. Ct. 136, 139, 58 La. Ed. 285. The depletion effected by production is likened to the depreciation of machinery or the using up of raw materials in manufacturing. *United States v. Ludey*, 274 U. S. 295, 302, 303, 47 S. Ct. 608, 610, 611, 71 L. Ed. 1054; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370, 45 S. Ct. 274, 275, 69 L. Ed. 660. Compare *Von Baumbach v. Sargent Land Co., supra*, 242, U. S. at pages 524, 525, 37 S. Ct. 201, 208, 209, 61 L. Ed. 460.'" *Sunray Oil Co. v. Commissioner of Internal Revenue*, 147 Fed. (2d) 962, 965, 966, (C. C. A. 10th).

"(1) 1. The assignment and transfer of a producing oil and gas lease for cash and a reservation of an overriding royalty in some states, is the sale of the oil and gas in place, and in others, a sublease. The assignment, therefore, in the present case

would be a sale in some states and a sublease in others, dependent upon local law. In applying the income tax statute, however, the Supreme Court has held that technical distinctions of local laws will be disregarded, and the statute will be interpreted so as to apply uniformily." *Hogan v. Commissioner of Internal Revenue*, 141 Fed. (2d) 92, 94, (C. C. A. 5th).

". . . The production of oil and gas is an income producing operation, not a conversion of capital investment. *Anderson v. Helvering*, 310 U. S. 404, 60 S. Ct. 952, 84 L. Ed. 1277; *Pettit v. Com'r*, 5 Cir., 118 F. (2d) 816; *Columbia Oil & Gas v. Com'r*, 5 Cir., 118 F. (2d) 459; *Com'r v. O'Shaughnessy, Inc.*, 10 Cir., 124 F. (2d) 33.

"It being the accepted view now that the receipts of oil payments are the result of an income producing operation, and not of one which merely returns capital, it follows that the theory on which the Laird case was rested, that the receipts of oil payments were returns, not of income but of capital, has fallen and that the case must be regarded as overruled." *Lee v. Commissioner of Internal Revenue*, 126 Fed. (2d) 825, 826, (C. C. A. 5th).

"Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199, on which appellant relies does not support him but is quite to the contrary effect. For, it makes clear that federal taxing statutes must be construed and given effect in the light of the taxing purpose they evidence and they will not be wrested out of the ordinary meaning their words

convey, to conform them to particular state legal concepts. There the court, declaring that a mineral lease with payment of a bonus was not a sale within the capital gains statute; that the bonus was merely an advance payment of royalties and subject to depletion allowance as royalty payments are; and pointing out that the capital gains statute was designed to overcome the evil of paying taxes in a lump in one year on gains accumulated over many years from the sale outright of assets in that year, held that it would be a perversion of the statute to construe it as applicable to a mineral lease, since returns come from it annually and not in a lump, and depletion is allowed on account of these returns, including the bonus.

"What was there said about state laws not being controlling upon the incidence of federal taxes was most appropriately said. The same thing was in effect said in Palmer v. Bender, 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489. There, a lessee of oil lands had transferred bonus and it was held that he had retained an economic interest which was depletable, without regard to the precise legal effect attributed under the state law to the instrument by which the transfer was effected." *Morrow v. Scofield*, 116 Fed. (2d) 17, 19, (C. C. A. 5th).

"Now in Texas, oil and gas in the ground are capable of ownership and sale separate from the soil which contains them, and leases such as are here involved convey to the lessee title to the oil and gas except such interests as are reserved to the lessor.

In Louisiana and many other states this is not true, but the lease only gives the lessee the right to use the land to capture the oil and gas which belong fully to no one until reduced to possession. Neverless, in order to give the federal income tax laws a uniform operation throughout the United States, these local differences are ignored in dealing with income and deductions; and an oil and gas lease is from the standpoint at least of the land-owner regarded as only a means of producing oil and gas from his land, and what he gets from it, whether in money or in oil or the proceeds of oil as produced, is income from the use of his land. Even when a lump sum is paid down by a lessee as a bonus in addition to a retained royalty, the bonus is considered as being an advance on royalties and to be income and not purchase money." *Commissioner of Intional Revenue v. Fleming*, 82 F. (2d) 324, 326, (C. C. A. 5th).

"(1) The income received by the lessor from an oil and gas lease, whether by way of an initial bonus or as royalties on the oil and gas subsequently produced by the lease, is taxable not as gain from the 'sale' or capital assets, but as ordinary income. *Burnet v. Harmel*, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199; *Murphy Oil Co. v. Burnet*, 287 U. S. 299, 53 S. Ct. 161, 77 L. Ed. 318; *Bankers' Pocahontas Coal Co. v. Burnet*, 287 U. S. 308, 53 S. Ct. 150, 77 L. Ed. 325; *Strother v. Burnet*, 287 U. S. 314, 53 S. Ct. 152, 77 L. Ed. 330; *Comar Oil Co. v. Burnet*, 64 F. (2d) 965; (C. C. A. 8); *Pitman v. Commis-

sioner, 64 F. (2d) 740 (C. C. A. 10); *Commissioner v. Jamison Coal & Coke Co.*, 67 F. (2d) 342 (C. C. A. 3)." *Umsted, et al., v. Commissioner of Internal Revenue*, 72 Fed. (2d) 328-329, (C. C. A. 8th).

". . . Such leases did not convey title to the oil and gas in place. They only gave the lessee the right to go upon the land and to prospect for, develop, and remove oil and gas therefrom. Under them the respective lessees would acquire title only to the oil and gas which they extracted and reduced to possession. *Hover v. McNeill*, 102 Kan. 492, 175 P. 150; *Finch v. Beyer*, 94 Kan. 525, 146 P. 1141; *Priddy v. Thompson* (C. C. A. 8) 204 F. 955; *Alexander v. King*, (C. C. A. 10) 46 F. (2d) 235, 238, 239, 74 A. L. R. 174. The bonuses were therefore in the nature of advanced royalties and were income from the land. *Burkett v. Commissioner*, (C. C. A. 8) 31 F. (2d) 667; *Berg v. Commissioner*, 59 App. D. C. 86, 33 F. (2d) 641; *Work v. Mosier*, 261 U. S. 352, 357, 43 S. Ct. 389, 67 L. Ed. 693; *Alexander v. King*, (C. C. A. 10) 46 F. (2d) 235, 239, 74 A. L. R. 174." *Ferguson v. Commissioner of Internal Revenue*, 59 Fed. (2d) 891, 892, (C. C. A. 10th).

Profits are income for purposes of internal revenue. Under Article 2402 of the Revised Civil Code, the profits from the separate estate of the husband fall into the community. There can be no doubt, from a consideration of income tax statutes, regulations and laws, that royalties are among the profits subject to taxation. *Section #114 "Basis for Depreciation and Depletion-"* clearly shows the purpose of Congress that royalties shall be considered as

income, subject to a rate of depreciation that would theoretically restore to the owner of the land its capital value. Since Congress has enacted that royalties are income, it lies within the power of no state to nullify the congressional purpose by providing that royalties are not income but a return of capital. The interdiction of such a power in any state has been pronounced by Your Honors in numerous cases.

It would seem true, with the inflexibility of mathematics, that royalties on oil producing land in Louisiana are rent and so fall within the definition of gross income as defined by Congress. The exertion of the constitutional power of Congress over income taxation gives it the right to define what shall be income. The exercise of that power is not subject to state control. It is not within the power of the State of Louisiana to say what Congress has defined as income is not income. The power of the state to define royalties is controlled by the paramount power of Congress, and Congress having declared that royalties are income the state is without right to say that they are not income. If they be income, subject to taxation by the Federal Government, then, they must be income for every purpose connected with income taxation under the laws of Congress. They cannot be income for purposes of levying a tax and not income in connection with their destination when measuring the tax.

A lengthy brief has expounded a long argument which could have been compressed in a contention tersely stated. The argument is susceptible of being reduced to the simplicity of syllogistic reasoning to reach the juri-

dical conclusion. Congress has defined gross income as including "profits" or "growing out of the ownership of property" and the controlling jurisprudence holds that royalties grow out of the ownership of land. Article 2402 of the Revised Civil Code provides that community income consists "of the profits" of the separate property of the husband and jurisprudence has recognized the right of a Louisiana husband and wife to make community returns, including rents from the separate property of the husband as community income. Therefore, since Congress taxes income from the ownership of land and Louisiana jurisprudence recognizes as community income the consideration for the use of the property of the husband, Warren J. Harang had the right to return his royalties, defined by federal and Louisiana jurisprudence as rent and as community income.

Respectfully submitted,

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[Of Counsel]